STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of **JOHN E. MCDERMOTT, JR.** for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Year 1998.	: : : : :	DETERMINATION DTA NO. 820099

Petitioner, John E. McDermott, Jr., 6001 Pelican Bay Boulevard, Unit 1106, Naples, Florida 34108, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the year 1998.

A hearing was held before Thomas C. Sacca, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on June 10, 2005 at 10:30 A.M., with all briefs to be submitted by September 24, 2005, which date began the six-month period for the issuance of this determination. Petitioner appeared *pro se*. The Division of Taxation appeared by Christopher C. O'Brien, Esq. (Kevin Law, Esq., of counsel).

ISSUE

Whether, pursuant to section 114 of Title 4 of the United States Code, New York State is precluded from imposing personal income tax on income received by a retired nonresident taxpayer from a New York partnership where the income is based upon the profits of the partnership.

FINDINGS OF FACT

1. Petitioner, John E. McDermott, Jr., is a resident of Florida, residing at 6001 Pelican Bay Blvd., Unit 1106, Naples, Florida 34108. In 1998 he was a resident of Connecticut and had been a Connecticut resident since 1966. Petitioner was a nonresident of New York State in 1998.

2. Petitioner was born on August 8, 1931. He is a lawyer and member of the bars, with retired status, of New York, Connecticut and the District of Columbia.

3. Coudert Brothers is a law firm with offices within and without New York State. Petitioner was employed and worked at Coudert Brothers' New York City office from 1965 through 1997.

4. In 1965 petitioner joined Coudert Brothers as a tax associate. He became a general partner on January 1, 1970. He worked for 33 years and retired on December 31, 1997 at age 66. He has performed no services for Coudert Brothers after retirement and has been fully retired from the practice of law since that time.

5. General partners at Coudert Brothers, during the period in which petitioner was employed by the firm, were compensated by the annual payment of shares in the firm's profits, called "profit shares." The number of profit shares, which a partner would receive annually, was determined by a compensation committee, which adjusted the amount annually to reflect a partner's productivity.

6. In 1970, and at all times thereafter until petitioner's retirement, Coudert Brothers Partnership Agreement contained Article 8(D) "Phase-Down and Retirement Income," which provided retirement compensation for Coudert Brothers general partners. Throughout the period

1970 through 1997, when petitioner retired, the provisions of Article 8(D), which affected petitioner's retirement compensation, remained substantially the same.

7. The retirement compensation provisions provided that general partners would be paid retirement compensation in the form of a continuing, but reduced number of profit shares for a period of years after retirement based on the number of years the partner was employed at Coudert Brothers and his productivity as a partner during his employment. Under Article 8(D), a general partner of the firm would receive, as retirement compensation, 20 percent of the highest number of profit shares held by the general partner in any one of the 10 years preceding retirement. In addition, he or she would receive such 20 percent for 14 years if the general partner was employed at Coudert Brothers for 20 years. An additional year is added for each five years of service after 20 years. The total amount of retirement compensation paid to all retired partners in a calendar year is subject to a 12.5 percent cap.

8. Petitioner was employed at Coudert Brothers for 33 years, including service as an associate. During each of the years that petitioner worked for Coudert Brothers as a general partner, his payment for his annual service, under the partnership agreement, was current compensation in the form of profit shares in current partnership income and, under Article 8(D) of the partnership agreement, rights to future profit shares, as retirement compensation, to be paid after retirement. Petitioner accrued these rights to future payments year-by-year over his 33 years of service. Petitioner's rights to payment of retirement compensation were fixed, as they accrued each year, and the firm could not, unilaterally, reduce or eliminate them. At the date of his retirement on December 31, 1997, petitioner's accrued rights to future payments of retirement compensation were fully earned and could not be unilaterally reduced or eliminated by the firm. Under the agreement, petitioner withdrew from Coudert Brothers on December 31,

1997, the date of his retirement. As of this date, according to Article 8(D) of the partnership agreement, his “period of firm association” ceased.

9. During the 10-year period prior to retirement, petitioner earned 56 profit shares in current partnership income as his highest number of profit shares in current partnership income earned during that period. Therefore, under the Article 8(D) formula, his accrued rights to future payments of profit shares as retirement compensation amounted to 20% of 56, or 11.2 profit shares per year in future partnership income after retirement.

10. Under the Article 8(D) formula, petitioner, by virtue of his 33-year period of service, accrued rights to receive the payment of 11.2 profit shares annually, for a period of 16 years after retirement. In summary, petitioner’s accrued rights to future payments amounted to a total of 179.2 shares, to be paid at the rate of 11.2 profit shares per year, over the 16-year period after retirement, from 1998 through 2013.

11. The material terms of the Article 8(D) formula in the partnership agreement, under which petitioner accrued his rights to future payments of retirement compensation over 33 years of service, were in writing and provided for the calculation of the amount of the payment of profit shares he earned and the period of time in which the profit shares were to be paid to him. After petitioner performed the services to earn the rights, the future payments could not be unilaterally reduced or eliminated by Coudert Brothers.

12. During the year 1998 petitioner was paid the first installment of retirement compensation. He was paid 11.2 profit shares in the firm’s 1998 partnership income. Each share had a value of $10,589.00, for a total value of all 11.2 profit shares of $118,596.80, rounded at $118,601.00 in the New York State Form K-1, of which $47,713.00 was allocable to New York State under the firm’s allocation percentage of 40.23%.

13. Coudert Brothers reported the $118,601.00 value of the payment of 11.2 profit shares to petitioner for 1998 under its retirement program, in the 1998 New York State Form K-1, which it was required to file and did file with New York State. The law firm inserted the following message on the Form K-1: "Retirement Income Payments are retirement income paid to a retired partner over a period of fourteen years or for life pursuant to a non-qualified deferred compensation plan sponsored by the firm."

14. Petitioner included the value of all of his 1998 11.2 profit shares in his Connecticut income tax return for 1998 and paid tax thereon.

15. Petitioner performed no service for Coudert Brothers in 1998. The award of 11.2 profit shares was solely attributable to petitioner's rights accrued under Article 8(D) of the partnership agreement during his 33 years of service to the firm.

16. In 1998, at the time the first profit shares were paid to petitioner, the value of profit shares to be paid in future years was not known. Since future annual profits would not necessarily be the same as in year 1998, the value of the profit shares over the remaining 15 years of the payout period would not necessarily be equal to the 1998 value. The value of profit shares paid by Coudert Brothers to petitioner over the years 1998 through 2003 was as follows:

Year	**Value per Profit Share**
1998	$10,589.00
1999	$11,262.00
2000	$ 9,874.00
2001	$11,364.00
2002	$11,092.00
2003	$10,331.00

The average profit share value for the years 1998 through 2003 was $10,752.00.

17. On May 5, 2003, the Division of Taxation ("Division") issued to petitioner a Notice of Deficiency of personal income tax due in the amount of $3,336.55. The Division explained in a Statement of Proposed Audit Changes that:

> [t]he partnership distribution from Coudert Brothers is considered New York source income and subject to New York Tax. Your interest in the partnership Coudert Brothers was not completely liquidated prior to you [sic] retiring. Since you maintained an interest in this partnership the income you received is not considered retirement income.

CONCLUSIONS OF LAW

A. Tax Law § 631(a)(1) provides that the New York source income of a nonresident individual shall include, among other items, the sum of "[t]he net amount of items of income, gain, loss and deduction entering into his federal adjusted gross income, as defined in the laws of the United States for the taxable year, derived from or connected with New York sources . . . ." A nonresident individual's items of income, gain, loss and deduction derived from or connected with New York State sources are items, in part, attributable to a business, trade, profession or occupation carried on in New York State (Tax Law § 631[b][1][B]).

B. Petitioner concedes that the income he received from Coudert Brothers during the year 1998 qualifies as New York source income and would be subject to the imposition of New York personal income tax. However, petitioner contends that New York State is precluded from imposing an income tax on such payments as they constitute retirement income within the meaning and intent of section 114 of Title 4 of the United States Code. Section 114 contains a limitation on State income taxation of certain pension income and provides, in relevant part, as follows:

> (a) No State may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State (as determined under the laws of such State).

(b) For purposes of this section -

(1) The term “retirement income” means any income from -

* * *

(I) any plan, program, or arrangement described in section 3121(v)(2)(C) of such Code, if such income -

(i) is part of a series of substantially equal periodic payments (not less frequently than annually) made for -

(I) the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient), or

(II) a period of not less than 10 years . . . .

Section 3121(v)(2)(C) of the Internal Revenue Code defines a “nonqualified deferred compensation plan” as any plan or other arrangement for deferral of compensation other than a plan described in section 3121(a)(5) 0f the Internal Revenue Code (generally, ERISA or “qualified” plans).

C. Section 114 of the United States Code contains two conditions to the prohibition of state taxation of nonresident retirement income from a nonqualified retirement plan. The first condition, set forth in section 114(b)(1)(I), is that such a retirement plan must be one described in section 3121(v)(2)(C) of the Internal Revenue Code.

Treas Reg § 31.3121(v)(2)-1(b) states that an acceptable plan, program or arrangement must provide for the deferral of compensation within the meaning of subsection (b)(3) and that the material terms of the plan must be in writing, i.e., the method or formula for determining the amount of deferred compensation and the time when it will be distributed. Subsection (b)(3) of Treas Reg § 31.3121(v)(2)-1 states that a plan provides for the deferral of compensation only if there is a legally binding right to the compensation during a calendar year and that under the terms of the plan, such compensation is payable in a later year. In addition, there is no legally binding right to compensation if that compensation may be unilaterally reduced or eliminated after the services creating the right to compensation have been performed. Finally, compensation is not considered subject to elimination or reduction merely because it may be reduced or eliminated by the objective terms of the plan such as the application of an objective provision creating a substantial risk of forfeiture or because benefits are reduced due to investment losses or decreases in compensation.

Article 8(D) of the Coudert Partnership Agreement is a compensatory arrangement, as the 11.2 profit shares paid to petitioner in 1998 were compensatory in nature. The profit shares were paid for services over 33 years and for productivity during that service. Coudert Brothers compensated its partners for legal services through the payment of shares in the firm's profits. The law firm compensated its partners for current services by awarding them a share in current profits and the right to share in future profits after retirement.

The written formula of Article 8(D) states the material elements, i.e., a formula for determining the amount of deferred compensation and the period of time during which it will be paid. The formula uses the highest number of profit shares earned during the final 10 years of service to measure the amount of retirement income, and the total years of service to measure the period of time over which the retirement compensation is to be paid. In addition, Coudert Brothers cannot, unilaterally, reduce or eliminate the amount of deferred compensation accrued or the period of time over which it is to be paid, once the required service is performed. Petitioner accrued the right to 11.2 profit shares during 33 years of service and Coudert Brothers cannot unilaterally reduce or eliminate those rights.

It is clear that Article 8(D) is a deferred compensation plan and the 11.2 profit shares paid to petitioner in 1998 is deferred compensation, meeting the first condition of section 114 of Title 4 of the United States Code.

D. The second of the two conditions imposed is contained in section 114(B)(1)(I)(i), which requires that the income be part of a series of substantially equal periodic payments made for a period of not less than 10 years.

The phrase "substantially equal periodic payments" is not defined for purposes of section 114(b)(1)(I)(i) of Title 4 of the United States Code. However, an analogous provision of the Internal Revenue Code has defined "substantially equal periodic payments" with regard to similar types of installment payments from qualified defined contribution plans. Pursuant to section 402(c) of the Internal Revenue Code, any portion of a distribution from a qualified plan that is an eligible rollover distribution described in section 402(c)(4) of the Internal Revenue Code may be rolled over to an eligible retirement plan described in section 402(c)(8)(B) of the Internal Revenue Code. Section 402(c)(4) of the Internal Revenue Code defines an "eligible rollover distribution" as:

> any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified trust; except that such term shall not include
>
> (A) any distribution which is one of a series of substantially equal periodic payments (not less frequently than annually) made
>
> * * *
>
> (ii) for a specified period of 10 years or more . . . .

Treas Reg § 1.402(c)-2, Q & A 5, provides that for purposes of determining whether a distribution is an eligible rollover distribution, the determination of whether a series of payments is a series of substantially equal periodic payments is generally determined at the time payments begin, and without regard to contingencies or modifications that have not yet occurred. However, with respect to a defined contribution plan, regulation section 1.402(c)-2, Q & A 5(d), provides that the following rules apply in determining whether a series of payments from a defined contribution plan constitute substantially equal periodic payments for a period described in section 402(c)(4)(A) of the Internal Revenue Code:

> (1) *Declining balance of years.* A series of payments from an account balance under a defined contribution plan will be considered substantially equal payments over a period if, for each year, the amount of the distribution is calculated by dividing the account balance by the number of years remaining in the period. For example, a series of payments will be considered substantially equal payments over 10 years if the series is determined as follows. In year 1, the annual payment is the account balance divided by 10; in year 2, the annual payment is the account balance divided by 9; and so on until year 10 when the entire remaining balance is distributed. . . .

Thus, the Internal Revenue Code has interpreted the phrase "substantially equal periodic payments" with respect to a qualified defined contribution plan to mean a series of payments from an account balance over a period if, for each year, the amount of the distribution is calculated by dividing the account balance by the number of years remaining in the period.

E. The Division has concluded that the above interpretation of the Internal Revenue Code, found in Technical Services Bureau Advisory Opinion TSB-A-96(7)I, of "substantially equal periodic payments" for purposes of a qualified defined contribution plan under section 402(c)(4)(A) of the Internal Revenue Code would also apply to the same phrase in section 114(b)(1)(I)(i) of Title 4 of the United States Code with respect to a defined contribution plan that is a nonqualified deferred compensation plan described in section 3121(v)(2)(C) of the Internal Revenue Code. The Division recognized that the amount of the installment payments made over the course of the payout will not be exactly equal.

The methodology is referred to in the Advisory Opinion as the "Declining Balance of Years" methodology of amortization. It allows the amortization of the retirement obligation over the specified payout period, in a uniform manner, while accounting, automatically, for differing annual profits and losses that will affect the payment of the obligation. The result is that, while the application of the amortization method will be uniform and will apply equally to each year, the dollar value of the annual payments can be unequal and will undoubtedly be unequal if the plan involves payments determined in whole or in part by profits. However, the entire obligation will be amortized over the specified period, while accounting for the differing levels of profit.

F. The Coudert Brothers retirement plan contained in Article 8(D) of the partnership agreement is a nonqualified defined contribution plan which requires the firm to contribute a fixed portion of its annual profits to a partner for a specified number of years. The value of the profit sharing obligation rises and falls annually, based on the firm's performance. Coudert Brothers is obligated to make to petitioner under the retirement plan a payment of a specified share in the firm's profits, whatever the value of that share may be. The obligation is not to make a payment of a specified dollar amount of the profits, but to pay a designated share of profits and to do so each year over the 16-year payout period. In 1998, at the beginning of the 16-year period, the total account balance of the legal retirement obligation owed to petitioner was 179.2 profit shares. By dividing total profit shares of 179.2 by the 16-years that Coudert Brothers is obligated to make payments under the retirement agreement, petitioner is entitled to receive the equivalent of 11.2 profit shares each year. Although the amount paid to petitioner each year will be different, the method employed to determine that amount is consistent throughout the period of the retirement payments, and therefore the series of payments is to be considered a substantially equal series of periodic payments made for a period of not less than 10 years (***see***, TSB-A-96[7]I).

G. As the payments made to petitioner pursuant to Article 8(D) of the Coudert Brothers Partnership Agreement constitute retirement income from a plan described in section 3121(v)(2)(C) of the Internal Revenue Code and are part of a series of substantially equal periodic payments made for a period not less than 10 years, New York State is precluded from imposing income tax on such payments, pursuant to section 114 of Title 4 of the United States Code.

H. The Division contends that a distributive share of partnership income to a partner who still maintains a capital account cannot be characterized as retirement income. In addition, the Division contends that section 114 of Title 4 of the United States Code does not apply to petitioner because he was a partner, not an employee, of the firm. Finally, it is the position of the Division that payments based upon the profits of a partnership cannot yield a series of substantial equal periodic payments, because of the obvious fluctuations in the firm's profits.

The issue of whether an individual is a member of a partnership is a question of fact (***see, Brodsky v. Stadlen***, 138 AD2d 662, 526 NYS2d 478). Factors to be considered include the sharing in profits and losses, exercising joint control over the business, making capital investment and possessing ownership interest in the partnership (***M.I.F. Securities Co. V. R.Stamm & Co.***, 94 AD2d 211, 463 NYS2d 771, ***affd*** 60 NY2d 936, 471 NYS2d 84). No one factor is dispositive of the issue of whether a partnership relationship exists, since all elements of the relationship must be considered (***Ramirez v. Goldberg***, 82 AD2d 850, 439 NYS2d 959).

The mere participation in the profits does not in itself necessarily make the recipient a partner (***Martin v. Peyton***, 246 NY 213). A profit sharing arrangement is considered but is not decisive in the determination of whether a partnership exists, since such an arrangement may be merely the method to accomplish some other purpose, such as the payment of retirement benefits (***see***, ***Martin v. Peyton***, ***supra***). An agreement to share in the profits is distinguishable from conferring the right which a partner has to profits as such (***Jacobs v. Escoett***, 265 AD 111, 37 NYS2d 789). Thus, an agreement to distribute a percentage share of the profits of a business does not make the recipient a partner if the enterprise does not represent a joinder of property, skills and risks (***Matter of Steinbeck v. Gerosa***, 4 NY2d 302, 175 NYS2d 1, ***appeal dismissed*** 358 US 39).

In the present matter, petitioner did receive his retirement income in the form of profit shares, and did maintain a capital account in Coudert Brothers. However, the partnership agreement provided that a retiring partner was to withdraw from the partnership, and as it is well settled that the duties and responsibilities are generally governed by the agreement between the partners (***Lanier v. Bowdoin***, 282 NY 32, ***rehearing denied***, 282 NY 611), it is concluded that petitioner, following his retirement, was no longer a partner of Coudert Brothers with all the rights and duties that the partnership agreement and New York State Partnership Law provide.

As to the Division's contention that retirement payments based upon the profits of a partnership cannot yield a series of substantial equal periodic payments, because of the obvious fluctuations in the firm's profits over a time period of 16 years, it is noted that the determination of substantial periodic payments is made at the time that the first payment is made (***see***, Treas Reg § 1.402[c]-2, Q & A 5; TSB-A-96[7]I). The Division recognized in its advisory opinion that payments based on profits will undoubtedly be unequal, but as long as the method used to determine those payments is uniform, such payments are to be considered a series of substantial equal periodic payments.

I. The petition of John E. McDermott, Jr. is granted, and the Notice of Deficiency issued on May 5, 2003 is canceled.

DATED: Troy, New York
February 2, 2006

/s/ Thomas C. Sacca
ADMINISTRATIVE LAW JUDGE